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This memorandum was prepared for Mr. Frank Vargo, Deputy Assistant Secretary of Commerce by [redacted] the Office of European Analysis, to be used for general background information.

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Washington, D.C. 20505

DIRECTORATE OF INTELLIGENCE
2 May 1986

The EC Budget: Crisis Ahead

Summary

The European Community is facing a budget shortfall this year of at least 2.9 billion European currency units (ecu) as now estimated by the Commission, mostly because of larger export refunds on agricultural commodities necessitated by the more than 34-percent depreciation of the dollar against the ecu since early 1985. This figure is probably understated by as much as 1 billion ecu because world farm prices are likely to fall as a result of the new US effort to subsidize agricultural exports, costing the Community even more in export refunds. The shortfall will throw the Community into one of its periodic fiscal crises, requiring the 12 members to implement a supplemental budget with additional member contributions. To avoid spending beyond the current maximum of 1.4 percent of member state value-added tax collections, some cuts in the budget will have to be made, but agriculture is likely to survive unscathed.

Most cuts and spending deferrals will likely come in the social and regional programs, important to many of the poorer member states, and in spending for job creation and research. The budget crisis will set back the Commission's efforts to establish a role for itself outside of agriculture, exacerbate tensions between the northern and southern tiers of Community members, and make it more difficult for the EC to find the funds needed to compete with the other major agricultural exporters, especially the United States. [redacted] 25X1

This typescript was prepared by [redacted] the Office of European Analysis for Deputy Assistant Secretary of Commerce Frank Vargo. Questions and comments may be directed to [redacted] Chief, European Issues Division, [redacted] 25X1 25X1

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The Budget Shortfall

The European Community's impending budget crisis arises because:

- The Treaty of Rome founding the EC forbids the Community from borrowing money to cover a shortfall.

- The Community can finance only 2.4-billion of the 2.9-billion ecu gap by upping to the maximum--1.4 percent--member state contributions to the budget from their value-added tax (VAT) collections.

The remaining 500 million ecu of commitments, as in past crises, will likely be dealt with through a combination of cuts, deferral of spending, and counting extra spending in 1986 towards the 1987 budget. The 2.9-billion ecu shortfall includes 1.5 billion ecu of additional agricultural spending that violates the 1984 EC agreement on fiscal discipline, stating as a goal that farm spending increase at the same rate as available revenues. The rest of the 2.9-billion ecu shortfall is made up of 800 million ecu of unfunded commitments from past EC budgets for social and regional development, 400 million ecu for an unexpected increase in the rebate to the UK, and 200 million ecu for unexpected regional development spending in Spain and Portugal. [redacted] 25X1

Factors Influencing the Crisis

The 1.5 billion ecu in extra agricultural spending is the direct result of the depreciation of the dollar against the ecu and an aggressive EC farm export strategy to dispose of its vast stockpiles of surplus production. The dollar/ecu rate affects the farm budget--one-third of which is made up of export refunds--because EC commodities sold on the world market are denominated in dollars. In general, as the dollar declines, the Community receives fewer ecu from EC exports, thus widening the gap between the world price--as expressed in ecu--and the internal EC ecu price. The Commission has estimated that a 10-percent fall in the dollar costs the Community an extra 800 million ecu in export subsidies, and some outside observers put the figure at 1 billion ecu. Thus far, the dollar has fallen 16.5 percent against the ecu since last September, and 34 percent since February 1985. The Commission's original dollar/ecu exchange rate assumed for the 1986 budget was US$1=1.2 ecu, or about 20 percent above the current rate of 1.03 ecu. [redacted] 25X1

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[redacted]

The 1985 US Farm Bill also threatens to require raising EC export refunds later this year--perhaps another 1 billion ecu beyond the Commission's estimate of 1.5 billion ecu--and put even more pressure on the budget by lowering the level of world prices. Thus far world prices have not been a significant factor in causing the shortfall. However, the US Department of State's INR has estimated that lower US support prices already in effect and increased export subsidies mandated by the bill could lower world wheat and corn prices 30 percent or more and keep them at that level until 1990.* The Commission's own plans for selling off the EC's farm surpluses using even larger subsidies, and the plans of other major exporters to do the same, will also act to depress world commodity prices. [redacted] 25X1

The other elements of the shortfall--the backlog of unpaid commitments and the larger than expected UK rebate and Spanish and Portuguese spending--are primarily the result of past budgetary decisions. The Commission counts a total of 1.169 billion ecu of unpaid commitments in the structural funds--monies appropriated to the member states for regional and social development--but proposes that only 800 million ecu be considered for funding this year. In past years the EC had deferred certain discretionary spending, often to accommodate agricultural spending. The unpaid commitments have begun to reach unmanageable heights, however. This year, because of higher than expected collections of VAT, the UK is owed a larger rebate--400 million ecu more--under the terms of the 1984 budget deal providing the UK an automatic reduction in its budget contribution amounting to two-thirds of its net contribution. Likewise the Commission was taken by surprise at the speed--twice as fast as expected--with which new members Spain and Portugal began to spend money under the regional and social development funds, creating a 200-million ecu shortfall. [redacted] 25X1

Options to Resolve the Crisis

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*The estimate is based on cuts in US support prices of 27 percent for wheat and 25 percent for corn and the use of over $2 billion in export subsidies over the next three years to make US farm exports more competitive. The US, with 150 million tons of grain stockpiled, is the world price leader. The support price cut is not likely to discourage US production because farmers will receive additional direct payments that will make up the difference between actual market price and a higher "target price" set by Congress to guarantee farm income. The estimate assumes normal growing conditions around the world. [redacted] 25X1

[redacted] 25X1

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As the EC is forbidden by its founding treaty to indulge in deficit spending, the budget shortfall must be made up by a supplemental budget funded by special member state contributions, which are limited by a 1.4-percent of VAT contribution ceiling. Supplemental budgets are often necessary to adjust for factors--farm prices and the dollar exchange rate--which can only be estimated in the formal budget; this year, they proved grossly understated. The member states probably will not act upon the supplemental budget proposed by the Commission until sometime this autumn when money is literally running out. The European Parliament must also vote its approval. 25X1

The supplemental budget will likely cut non-agricultural spending--on research, social and regional development, and job creation. The Commission also has the option--though technically illegal--to spend amounts above the ceiling by counting the expenditures in the next year's budget, or to stretch out payments over several years. This is the same practice, used by the Commission for many years to accommodate member state political compromises on spending, that created the at least 800-million ecu shortfall in unfunded commitments this year. Agricultural spending has traditionally never been cut to meet the requirements of the budget because of the enormous political pressures in the member states to appease the farm vote. The EC Agriculture Ministers just agreed on 25 April to freeze the level of ecu farm prices for the next marketing year. In practice, however, the "freeze" means price increases of between 1.5 and 18 percent in national currency terms--except for West Germany and the Netherlands--because of the recent realignment of the European Monetary System. 25X1

The member states are not likely to agree this year to raise the VAT contribution ceiling above 1.4 percent. The 1.4-percent ceiling just came into effect at the beginning of this year as part of the solution to a long budget dispute concerning the UK rebate and the need to boost revenues available to cover the increased spending associated with the addition of Spain and Portugal. Any increase in the VAT ceiling requires ratification by all member state parliaments. The UK and West Germany--the strongest advocates of fiscal restraint because of their position as net contributors to the EC budget--are firmly against raising the VAT ceiling until at least 1988. Advance budget estimates prepared by the Commission indicate that the ceiling will have to be raised to 1.6 percent in 1988 to meet the growth in spending as Spain and Portugal become integrated into the Common Agricultural Policy. 25X1

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The 1984 agreement on fiscal discipline will probably not play a major role in the present budget crisis. The agreement, with no legal force, allows for spending to exceed the restrictions under "exceptional circumstances" such as enlargement. Italy has suggested that the present shortfall represents such a circumstance. However, the EC Court of Justice could rule this summer that the 33.3-billion ecu 1986 budget voted by the European Parliament and now in force is illegal because it exceeds the 32.7-billion ecu budget agreed to by the Council of Ministers under the fiscal discipline agreement. The Council brought suit against the Parliament, alleging that the Parliament had overstepped its constitutional bounds, and the Court in a preliminary ruling has forbidden the Commission from spending any more than 32.7 billion until the Court provides a final judgment. The dispute, although significant in constitutionally delineating the Council's and Parliament's powers, is largely irrelevant to the budget crisis and would not affect the implementation of a supplemental budget. 25X1

Implications

The budget crisis will rob time from EC decisionmakers' consideration of other issues and create dissension among the member states, even as the shortfall and the need for spending restraint have made the budget the main forum for policy debate over the future of the Community. The Community will be forced to weigh carefully what new policies and programs it thinks it needs and can afford. It seems likely that the spending cuts on research, high technology, and industry will frustrate the EC's effort to establish a role for itself outside of the agricultural sector in support of greater European competitiveness. An ambitious 10-billion ecu research program proposed by the Commission for 1987-91 has already been shelved until at least 1988 at the suggestion of West Germany because of the lack of funds. 25X1

A Community embattled over budgetary priorities will find it increasingly difficult to match the new US export subsidies mandated by the Farm Bill and similar new export subsidy schemes under consideration by other major exporters such as Canada, and could feel threatened with a loss of its world market share. The Community under these circumstances is likely to seek some kind of an accommodation with the United States on the use of export subsidies and is probably inclined to try to set up market sharing arrangements. The EC is faced with disposing of its surplus production--which is even more costly to store--while having to spend more and more on export subsidies to get rid of

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it in a world market of falling prices, partially caused by exporters using subsidies. Agricultural Commissioner Andriessen recently proposed a surplus disposal program for butter, beef, and other products costing over 1 billion ecu that could be paid for only with the proceeds of the proposed tax on grain production and other savings on the Commission's commodity management practices. Serious budget pressures over the long term--especially as Spain and Portugal come under the CAP--will probably encourage incremental reforms of the CAP. Member states acquiesced in the 1984 reforms of the CAP largely because of the budget crisis of that time. [redacted] 25X1

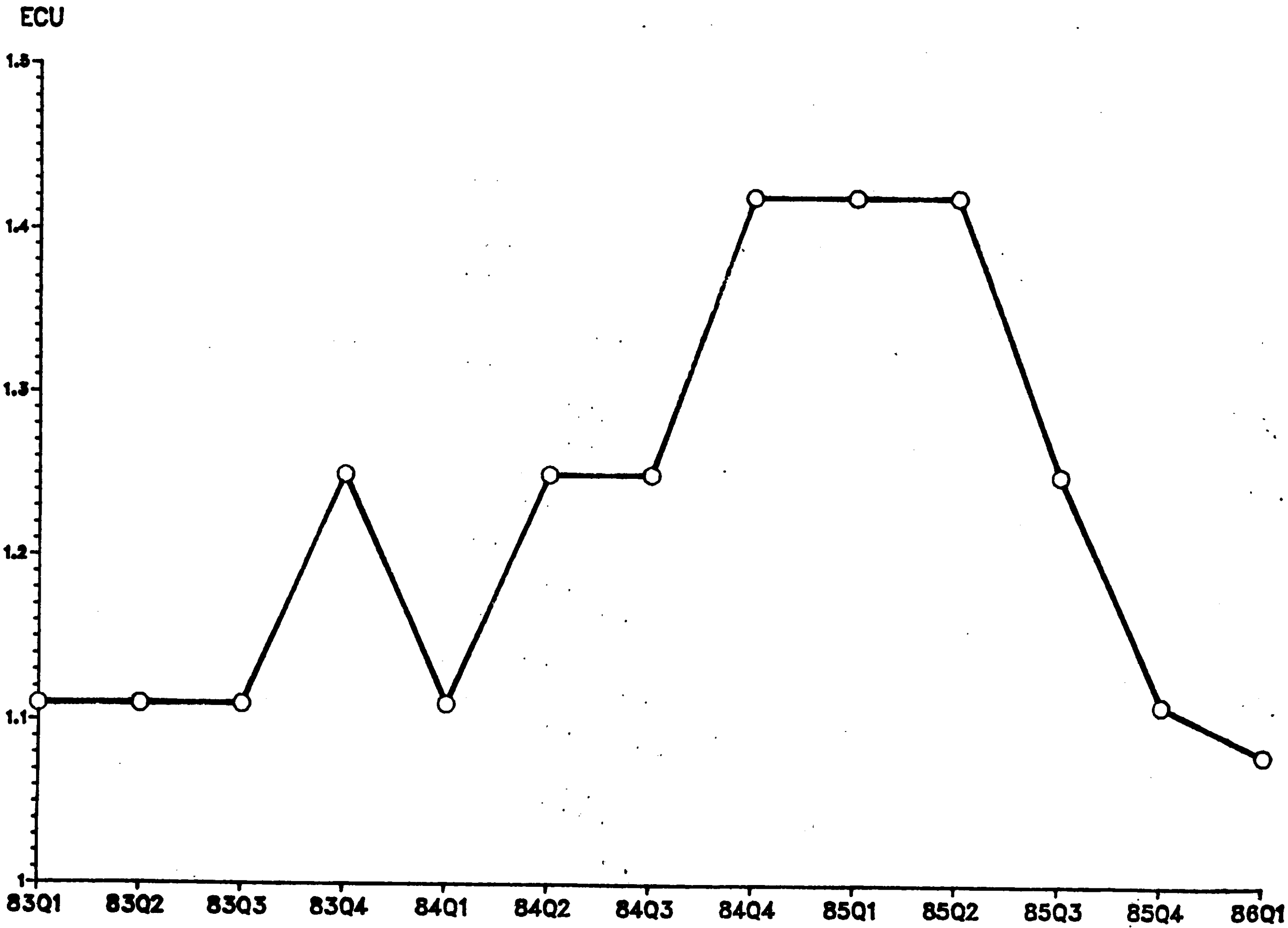
Tensions between the richer northern countries and poorer Mediterranean countries of the Community are likely to increase because of the likely budget changes. The near sacred agricultural spending is disproportionately oriented to northern products such as wheat and milk while the spending most likely to be cut, the social and regional funds, are resource transfers to the poorer regions of the Community in the southern Mediterranean countries. The southern countries are thus much more in favor of raising the VAT ceiling to provide additional revenues than the guardians of fiscal restraint in the north, the UK and West Germany. [redacted] 25X1

The potential north-south conflict could have serious consequences for the Community's drive to achieve a completely free internal market by 1993. Greece made its acceptance of recent institutional reforms, designed to speed the progress towards the free internal market, conditional on making explicit in the Treaty of Rome that the goal of the social and regional funds is to promote the convergence of member state economies. Should these resource transfer funds be decimated by the budget crisis, the least developed Community countries--Greece, perhaps joined by Spain, Portugal, and Italy--would have little direct incentive to cooperate in the complex task of creating the free internal market. [redacted] 25X1

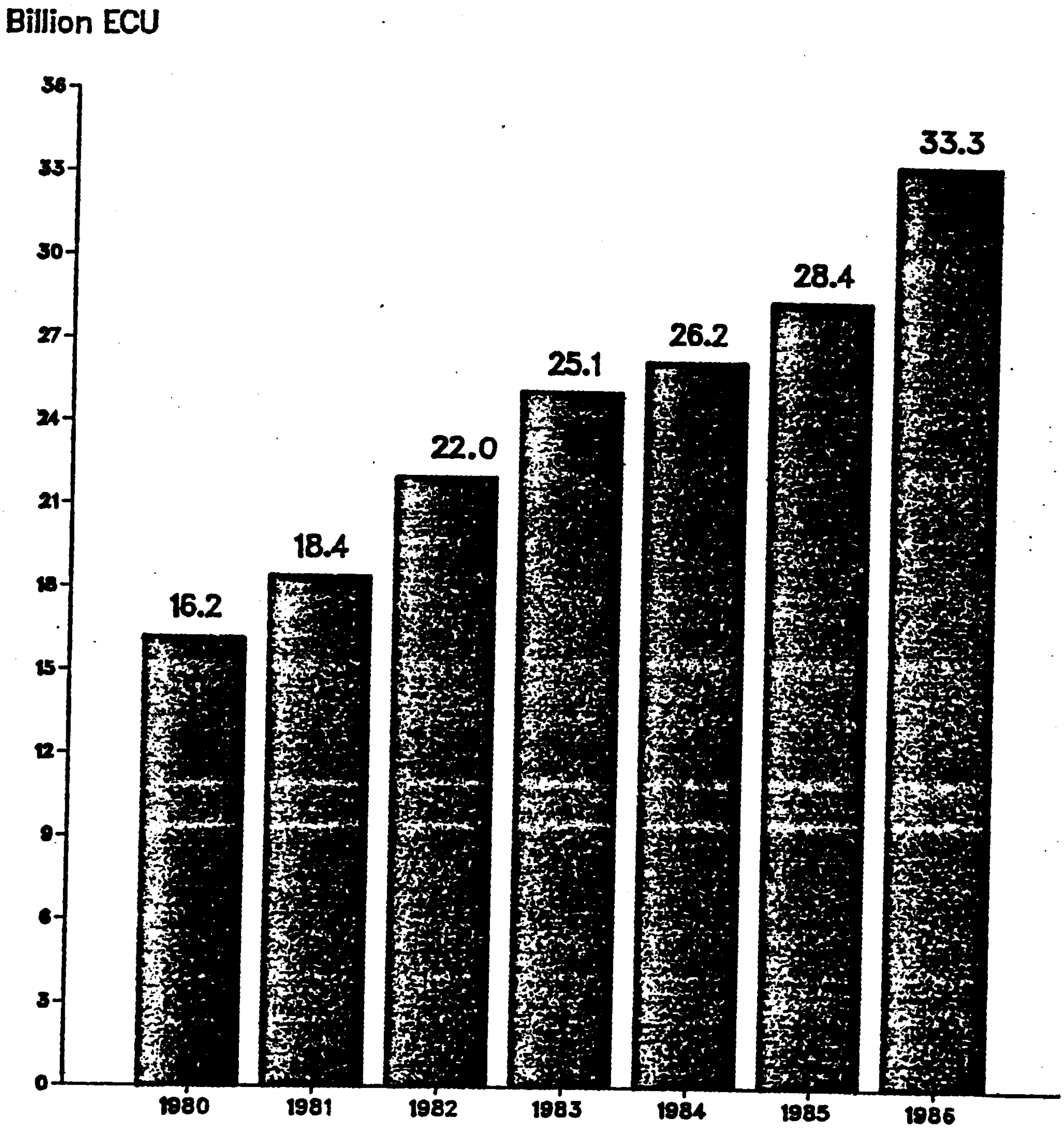
Finally, the budget crisis, especially because it has been fostered by the falling dollar, is likely to sharpen the Commission's and some member state's interest in international monetary reform in an effort to stabilize exchange rates. Commission President Delors is likely to raise monetary reform at the Tokyo Summit and at a minimum support recent G-10 and IMF Interim Committee recommendations to study the possibility of devising "objective" indicators of economic stability. [redacted] 25X1

[redacted] 25X1

US Dollar: Average Value Against the ECU



European Community: Total Spending, 1980–1986



EC: Budget Expenditures by Type, 1986
(33.3 Billion ECUs)